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Preface

This report follows in the wake of a nearly four-year process through which Gallatin County has attempted to identify the best ways to implement a Transferable Development Rights (TDR) program. In 2004, the Gallatin County Commission created a TDR Committee to study the plausibility of a County-wide TDR program. Then, in 2006 a private consultant was contracted to provide additional recommendations. This resulted in the County synthesizing the consultant's suggestions into a Draft TDR zoning regulation for the Gallatin County/Bozeman Area Zoning District and a "2006 Gallatin County TDR Guidebook."

The County Commission, however, was concerned about the potential outcomes of adopting a TDR policy without having a clear understanding of the underlying economics. This sparked concern over how the adoption of TDR policy may impact the County.

This report seeks to answer the Commission's questions and concerns and shed some light on the potential outcomes that TDR may have – both as proposed and under some alternative scenarios.

Executive Summary

As Gallatin County continues to grow, there is much debate as to where these homes should be built. Much of the County's previous growth has occurred in rural areas with little existing infrastructure to support such development. The lack of density restrictions and the discretionary nature of subdivision approvals have, over time, resulted in the ad hoc land development patterns seen in the Gallatin Valley today.

To address this problem the County is looking to adopt its 2006 Growth Policy Implementation Program, a comprehensive and multi-faceted program designed to implement the County's 2003 Growth Policy. Integral to the Implementation Program is a Transferable Development Rights (TDR) program that seeks to redirect development potential from the rural areas into designated growth areas using financial incentives. As a precursor to the TDR program, the County is looking to limit density in rural areas to 160-acre lot sizes through its subdivision regulations.

In a standard TDR program, the right to develop land is severed from the land itself and treated as a separate right. Landowners in "sending areas" (areas designated for preservation) are permitted to sell their development rights to landowners or developers in designated "receiving" areas, who are permitted to build at higher densities if they purchase development rights. Once the development rights are sold from the property, the land is typically protected from future development in perpetuity with a conservation easement.

The County's proposed TDR program would allocate TDRs to rural landowners contingent upon a deed restriction of their property that limits development potential beyond the 160-acre minimum lot size/density. The number of TDRs allocated to each parcel would be determined either by an acreage-based or a value-based method. It is important to note that the TDR program is simply a proposal at this point and the County Commission has not adopted either the program or necessarily underlying provisions. The Commission has not, for example, adopted a policy position as to whether the 160-acre requirement will be based on density or a minimum lot size.

The first step when approaching TDR in any locale should be a thorough evaluation of the demand side of the development rights market. A developer's willingness to purchase increments of density is the "engine" that drives the market - and without strong demand, a TDR program will struggle. Furthermore, knowing with a degree of certainty, how much developers are likely to spend for TDRs will give rural landowners an idea about the compensation they are likely to receive.

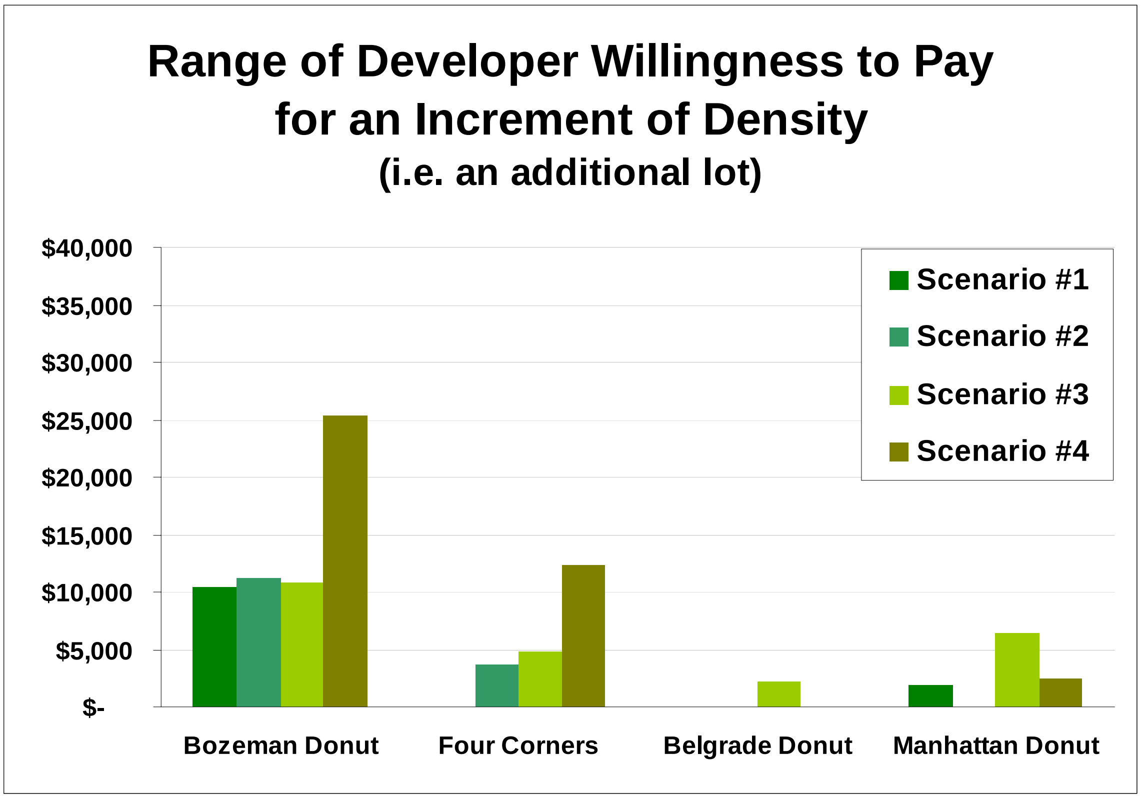
Our analysis finds that there is sufficient demand to drive a TDR market in Gallatin County. We find that developers' "willingness to pay" (WTP) is between $1,900 to $25,000 for additional density above the 1 unit per 5 acre base density - depending on location and development scenario.[1] Since development throughout all four proposed receiving areas (Bozeman Donut, Four

[1] In general, this willingness to pay ranges between 5% and 17% of the current selling price of improved lots.

Corners Planning Area, Belgrade Donut, and the Manhattan Donut) would not be the same, we model a set of most-likely development scenarios depending on subdivision density, lot size, and availability of infrastructure. For example, at present a developer in the Bozeman donut receiving area can build 1 lot on 5 acres, but he/she would pay up to $10,000 for the right to build additional lots at 3 units per acre. The average WTP is $7,229 across all receiving areas.[2] Chart ES.1 below shows the range of WTP results.

These figures represent static "snapshots" in time of what developers would pay now – they are subject to change with changing market conditions. If the real estate market strengthens in the future, the WTP is likely to go up; if the market cools considerably it will drop.

Chart ES.1



A threshold determinant of developer willingness to pay is the relationship between raw land costs, lot selling prices, and the cost/availability of infrastructure in the various receiving areas. The costs of tying into existing sewer/water or incurring the cost of an independent sewer/water system affect how much money developers have available to buy density. When these three cost variables are significant developers have little money left over to purchase TDRs.

It should also be noted that the results expressed above represent theoretical maximums that developers would pay in the market place. It is assumed that willing TDR buyers will seek to find

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[2] This is a weighted average based on the percentage of additional lots that could be built in each area.

prices well below their maximum willingness to pay. The actual or market price they pay will depend to a large extent upon the supply of available TDRs.

Under the current proposal, a total of 48,009 TDRs could be allocated to sending area landowners assuming 100% participation; since it is proposed that 1 TDR would equal 4 additional lots, this equates to 192,000 additional lots as the total supply that developers could purchase. On the demand side of the equation, we predict that with the County's 34,076 acres identified as potential receiving areas, there could be at total of 99,184 additional lots created at full buildout through TDR purchases.

Thus, in total terms, there is twice as much supply as there is demand. This ratio is desirable to ensure that enough supply exists to account for a certain number of sending site landowners who will not participate in the market. Any greater ratio would have too little demand chasing too much supply, and the currency (i.e. TDRs) would not retain its value.

The number of additional lots is, of course, a theoretical total. Actual TDR demand is based only on the number of additional lots developers looking to buy for their projects at a particular time. Likewise, the actual supply of TDRs available for purchase will depend on rural landowners' preferences and the extent of compensation they could receive through TDR sales (i.e. the TDR market price).

In terms of actual demand, on average, 1,000 lots are approved in the County each year (most of them in the City of Bozeman); this annual demand for additional lots represents 1% of the total we determined to be full buildout of the receiving areas. Furthermore, there is an existing supply of 3,074 lots that have received preliminary or plat approval – which is a three- year supply without the need for any TDR purchases. This rather large inventory of lots will initially diminish developer demand for TDRs and create a sluggish market during the program's first couple of years.

In terms of actual supply, TDR markets are traditionally "thin," meaning that at any given point in time there are only a few sending site landowners who are willing to participate in the market through a deed restriction of their property to sell TDRs. Gallatin County landowners can only be expected to participate if developers can meet or exceed a price that reflects the loss in property value as a result of the deed restriction. We found that, rural landowners may be willing to sell TDRs, on a lot basis, for between $5,000 and $8,750 (i.e. $20,000 to $33,000 per TDR).

Developer willingness to pay varied by receiving area, but developers in the Bozeman donut and a couple situations in Four Corners (development scenario 4) and Belgrade (development scenario 3) are willing to pay above $5,000 for additional units. Other development scenarios, in other areas cannot match the price at which landowners may be willing to sell TDRs. For example, developers in much of the Four Corners area will not be able to afford to pay for additional lots at $5,000 apiece. This is a problem since much of the County's growth is expected to occur in the Four Corners area.

Yet, in general, landowner willingness to sell aligns with developer willingness to pay. This means that TDR allocations using the proposed value-based "divisor", coupled with the fact that each TDR translates into 4 additional units - in theory - would act to effectively bring potential buyers and sellers together.

However, even though the economic rationality expressed through the willingness to sell and pay are in relative accord, it does not mean all landowners who can capture $5,000 (i.e. $20,000 per TDR) will participate. Some landowners have expressed concern that they will not recapture their perceived lost value through this system.

Few landowners are likely to permanently restrict the development potential of their property to be less than 1 unit per 160 acres, even though they might be able to recoup the loss in value through TDR sales. Among other things, landowners may believe that the County may increase their development potential in the future, even if the TDR program is put in place now. From a landowner's perspective the price of "forever" is not equivalent to the rational economics of today. For this reason development right markets are "thin" – often with few willing sellers, since most do not want to lose the opportunity to develop in the future.

For these reasons, we assume that the "actual" supply or amount of TDRs that landowners sell to developers in the market would be much less than the total supply. How much less is difficult to determine, since landowner preferences are hard to gauge over an area as large as Gallatin County.

We believe a reasonable assumption may be that 2,000 TDRs may be available to receiving-area developers each year -- twice the annual number of lots built each year, and a ratio similar to what we found to be the total theoretical supply to demand.

Thus, in the market there are likely to be developers needing half as many TDRs as there are available to buy. This will result in a TDR price that is less than the developer "willingness to pay". More specifically, developers who are willing to pay $10,000 for an additional unit in their subdivisions will witness a surplus when they only have to pay $5,000.

Yet, despite this economic theory, we believe there is still some reason for concern. In addition to setting up the TDR program, the County's pending proposal also creates 160-acre minimum lot size/density in rural areas. The combination of the lot-size restriction and the further deed restrictions through the use of TDRs may be difficult to accomplish through the program as proposed.

In an environment such as Gallatin County, with no preexisting comprehensive county-wide density limits, many rural landowners have the perception - whether rightly or wrongly - that they are entitled subdivisions with lots smaller than 160 acres --perhaps 5 acres, perhaps 10 or 20 acres. Some have expressed fear that they will lose value if the County imposes a restriction to 160-acre lots and will do so again if they cannot recoup their perceived development value through the TDR program.

Thus, some landowners may not perceive the TDR program as an incentive and may oppose it. If landowners choose not to use the program, it will be more difficult for the County to accommodate expected growth in the geographical configuration desired in the growth Policy. Even in the designated growth areas, the County may experience predominantly 5-acre lot development.[3] Either way, the land supply will not be available to developers, and therefore developers may cross the line to Broadwater County, as some already have, where development is easier and less costly.

For these reasons, we find it necessary that the County "decouple" landowner willingness to sell TDRs from a permanent deed restriction of his/her property that would further limit development potential beyond the initially imposed 160-acre minimum lot size/density.

As a first option, the County could consider a "term" TDR. In this case the landowner would deed restrict his/her property beyond the minimum 160-acre lot size/density, but only for a period of time, in exchange for TDRs. For example, in other areas of the Country 40 year deed restrictions are used.

The term-TDR would remove much of the risk that landowners associate with permanent deed restrictions since they are only forfeiting future development potential for a period of time. A deed restriction that sunsets will bring many more landowners into the market and lower the price at which they are willing to sell their TDRs. Furthermore, this approach will not create a significant barrier to development or hinder future growth. However, the County will have to revisit the question of developing these properties again in the future.

A second option would be to craft a variation on the value-based method of assigning TDRs. Under this concept, the County would eliminate the acreage-based method of assigning TDRs and instead use only the value-based method. To make this idea viable in the marketplace, the County should also eliminate the deed restriction requirement in the sending areas – permitting landowners to build 1 residence per 160 acres and selling the excess TDRs into the receiving areas. Because this system provides sending-area landowners with a commodity to sell, rather than a right to build, we would suggest calling this commodity a transferable development *credit,* or TDC, rather than a transferable development *righ*t.

Furthermore, to avoid flooding the market in the receiving area with credits, the transfer ratio in receiving areas should be changed from 4:1 to 2:1. That is, a credit sold by a sending-area landowner to a receiving-area developer would permit construction of 2 additional units in the receiving area.

The creation of this credit commodity should remove any landowner concern over permanent (or temporary) loss of development potential beyond the 160-acre minimum lot size/density restriction. This will reduce landowner risk, resulting in many more sending site landowners willing to participate in the market - making TDRs easier to come by for receiving area developers.

[3] This is because the base density in the growth area is 1 unit per 5 acres.

Importantly too, credits would be sold at a lower price since landowners do not have to recoup the loss in value created from a deed restriction. The lower price will make development in the receiving areas easier – especially those areas where the lack of infrastructure severely limits the amount developers are willing to pay for increased density.

Besides adjusting the program to decouple TDR/TDC allocations from a deed restriction, several other important components are needed to create a successful program in Gallatin County. These are: (1) address the need for infrastructure in the receiving areas, (2) maintain the TDR/TDC value through strict policy enforcement, (3) work with the cities in inter-jurisdictional transfers, and (4) establish a TDR/TDC bank to facilitate the market.

In sum, there is the potential for a viable market in tradable development rights – the economic incentives do exist. But, it is simply asking too much of TDR as a policy tool to simultaneously: accomplish 160-acre density limits in the rural areas, account for all of the County's future development in its growth areas, *and* achieve further limit development potential beyond the 160-acre minimum lot size/density regulation. If the County can let go of the latter and focus on just the first two goals, it can put in place a successful program.